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IN THE

Supreme Court of the United States

OCTOBER TERM, 1969

No. 38

CHARLES E. BRUNDAGE, et al., constituting the NORTHERN PACIFIC STOCKHOLDERS' PROTECTIVE COMMITTEE, *Appellants*,

v.

UNITED STATES OF AMERICA, et al., *Appellees*.

On Appeal From the United States District Court for the District of Columbia

BRIEF FOR APPELLANTS

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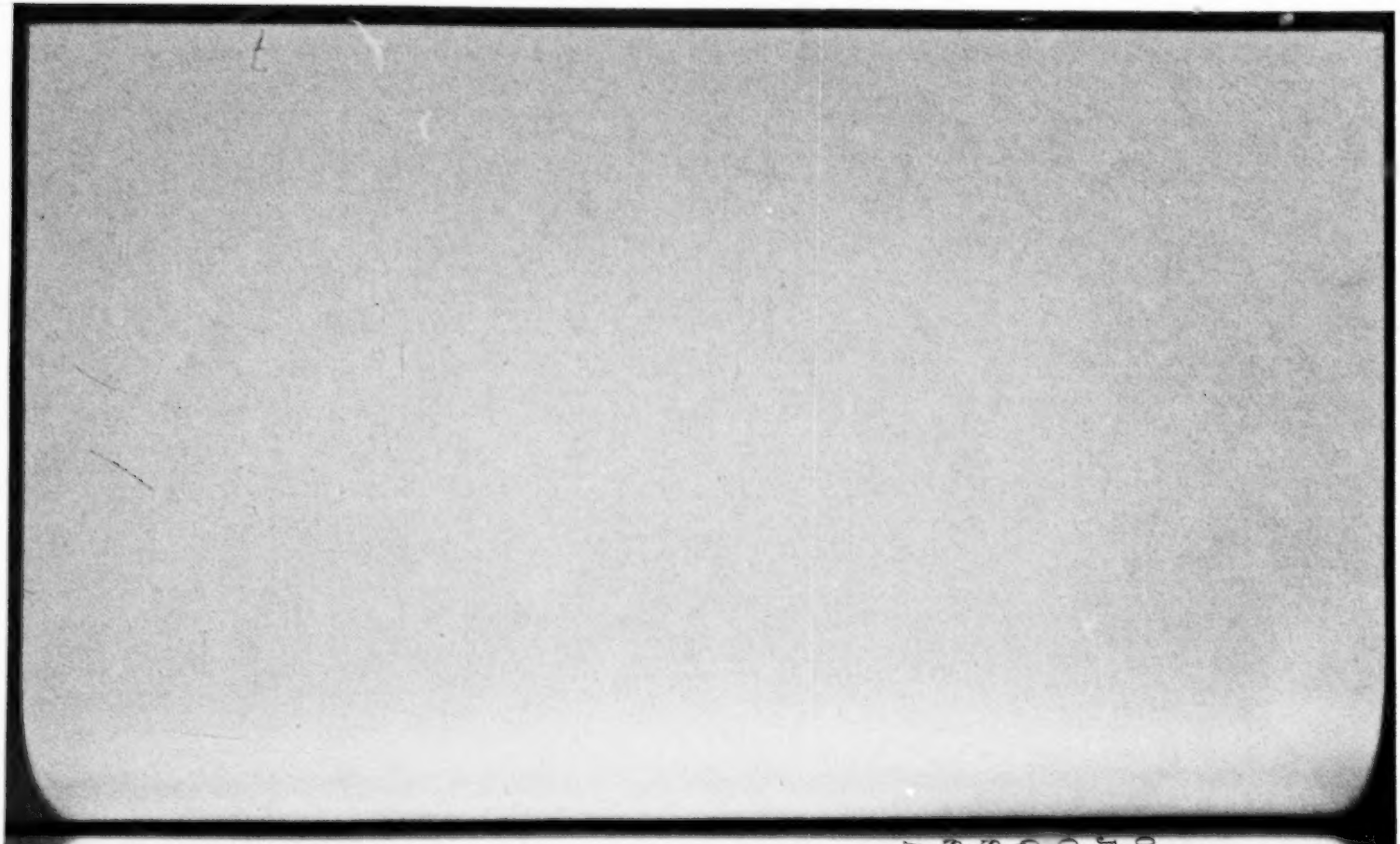

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BRIEF FOR APPELLANTS

OPINION BELOW

The opinion of the three-judge United States District Court for the District of Columbia (J. App. 1-58)*

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*"J. App." refers to the single joint Appendix in this appeal and in Nos. 28, 43 and 44, bound in separate volumes. "App. I.", "App. II.", etc. refer to the appendices herein, pp. 1a to 30a. "Tr." refers to the transcript of the proceedings in the I.C.C. where not reproduced in the Appendix.

is reported at 296 F. Supp. 853. The several decisions of the Interstate Commerce Commission are reported at 328 I.C.C. 205, 328 I.C.C. 460, 331 I.C.C. 228, 331 I.C.C. 869, and 333 I.C.C. 391. They also are included in the Appendix hereto at pp. 1258, 61, 245, 463 and 498, respectively. A subsequent order of the Commission dated April 23, 1969, is set forth in the Appendix hereto at p. 505.

JURISDICTION

The order of the three-judge district court denying an injunction against the orders of the Interstate Commerce Commission in issue was entered November 20, 1968 (J. App. 59-60). Notice of appeal was filed December 20, 1968. Probable jurisdiction was noted February 24, 1969. The jurisdiction of the Court is conferred by 28 U.S.C. 1253, 2101(b) and 2325.

CONSTITUTIONAL PROVISION AND STATUTES INVOLVED

The Constitutional provision and statutes involved in this case are:

U. S. Const. amend. V; 5 U.S.C. 554, 556, 557, 704, 706; 80 Stat. 398; 28 U.S.C. 1253, 62 Stat. 928; 28 U.S.C. 1336(a), 78 Stat. 695; 28 U.S.C. 1398(a), 78 Stat. 695; 28 U.S.C. 2101(b), 62 Stat. 961; 28 U.S.C. 2284, 62 Stat. 968; 28 U.S.C. 2321-25, 62 Stat. 969-70; Sections 5(1), 5(2) and 5(11) of the Interstate Commerce Act (49 U.S.C. 5(1), 54 Stat. 905; 49 U.S.C. 5(2), 54 Stat. 905, 63 Stat. 485; 49 U.S.C. 5(11), 54 Stat. 905). The pertinent texts of these Constitutional provisions and statutes are attached hereto as Appendix I.

QUESTIONS PRESENTED FOR REVIEW

1. Whether the record contains substantial evidence to support the finding of the Interstate Commerce Commission and the District Court that the stock exchange ratios are just and reasonable.

2. Whether the Commission and the District Court in finding the stock exchange ratios to be just and reasonable, failed to consider and review the whole record or those parts cited by the Committee.

3. Whether, acting on a 1962 record, the Commission erred, abused its discretion or violated due process in not requiring or permitting a further hearing in 1968 to receive evidence of the then current worth of the contributions being made to the consolidation by the various groups of stockholders, particularly with respect to the natural resources properties being contributed alone by Northern Pacific stockholders.

4. Whether the record contains substantial evidence to support the finding of the Commission that the Committee's proposed condition for the segregation and offer for sale to Northern Pacific stockholders, prior to merger, of the natural resources properties of Northern Pacific and the substitution therefor of cash in the consolidation was without merit and unfair to Northern Pacific stockholders.

STATEMENT OF CASE

This is an action to suspend, enjoin, annul and set aside orders of the Commission, dated November 30, 1967 (J. App. 457) and April 11, 1968 (J. App. 496) authorizing the consummation of the so-called "Northern Lines" merger involving first the merger of The Great Northern Railway Company, Northern Pacific

Railway Company and subsidiary companies and then a merger with Chicago, Burlington & Quincy Railroad Company into one New Company.* This appeal by the Northern Pacific Stockholders' Protective Committee ("Committee") is from an order of the United States District Court for the District of Columbia dismissing the complaint of the Committee and affirming the orders of the Commission which approved the stock exchange ratios set forth in the application to the Commission (J. App. 59). These ratios are as follows:

Northern Pacific stockholders would receive common stock of the New Company on a share for share basis. Great Northern stockholders would receive common stock of the New Company on a share for share basis plus one-half of a share of the New Company's $10 par value 5½ percent preferred stock for each share of Great Northern stock held at the date of the merger. The Burlington stock owned by Great Northern and Northern Pacific, totaling 97.18 percent of the total outstanding Burlington stock will be cancelled but the minority stockholders of Burlington will receive 3.25 shares of common stock of the New Company in exchange for each share of their Burlington stock. The preferred stock would be retired over a 25 year period beginning at the fifth anniversary of the merger and would be redeemable at the option of the New Company after the fifth anniversary of the merger (Application to Commission pp. 25-34; Tr. 51).

As a result of land grants from the U. S. Government under an Act of Congress of July 2, 1864 to en-

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* Herein called Great Northern, Northern Pacific, Burlington, and the New Company.

courage construction of a transcontinental railroad west from Lake Superior to Puget Sound, Northern Pacific, unlike the other parties to the merger, has vast lands and natural resources properties which contain oil and gas, timber, iron, coal and other minerals (Tr. 68-70; 9889-96). Originally Northern Pacific owned 39,473,369 acres of such lands in fee, and it now owns mineral and/or surface rights in approximately 8,314,000 acres, an area almost equal to that of the States of Massachusetts and Connecticut combined (Tr. 14360; Applicants' Ex. 26, p. 8). Of this 5,505,418 acres were deemed in 1959 to have oil and gas potentials (Com. Ex. 29, p. A6). Much of this land had not been explored for minerals and the mineral potential of this vast acreage was largely unknown according to Northern Pacific management (Com. Ex. 31, p. 5).

The discovery in 1951 of oil on these lands in the Williston Basin radically affected Northern Pacific's character, activities and earnings, resulting both in the establishment of a separate Oil Development Department within the company and the removal of its stock from the Dow-Jones Railroad Average (Tr. 9895, 9898, 14346). In 1961 more than one-third of the total net income of the Northern Pacific was from these natural resources properties (Com. Ex. 136, p. 19).

Before undertaking serious negotiation of merger terms, both Northern Pacific and Great Northern separately employed timber and oil and gas experts to value such properties, and Northern Pacific's staff made a "catch-all" appraisal of other mineral and surface rights, assigning no value however to "billions of tons of lignite, subbituminous and bituminous coal" (Com. Ex. 31, p. 2). A summary of these unsworn appraisal reports, dated in 1957, 1958 and 1959, appears

in Com. Ex. 32, at page 18. The values set forth in these unsworn appraisal reports commissioned by Northern Pacific total $202,694,457, including $32,700,000 worth of industrial properties.

In May 1959, Northern Pacific's financial advisor, Morgan, Stanley & Co., recommended that Northern Pacific not merge with Great Northern unless its stockholders received, as a minimum, a greater per share interest in the New Company than the per share interest to be received by Great Northern stockholders, with no provision for any preferred stock (Com. Ex. 32, pp. 27-8). Despite this recommendation, the proposed stock exchange ratios favoring Great Northern stockholders were agreed upon in June 1960 by the negotiators.

On February 17, 1961, the applicants filed with the Commission their application for approval of the merger.

In August 1961 the Committee was organized, and in October 1961 it intervened before the Commission.

The applicant railroads offered no testimony of any experts as to the value of the natural resources properties of Northern Pacific. Nor did they offer in evidence the various unsworn appraisal reports previously mentioned (Tr. 91-2). These reports were put in the record by the Committee, along with testimony of an oil geologist as to the favorable prospects of additional oil and gas discoveries on Northern Pacific's lands (Tr. 10057-71). The Committee also put in the record the testimony of three security experts (1) as to many factors specifically applicable to the valuation of natural resources properties but not applicable to railroad properties, (2) as to the recent market sales of listed

stocks of companies owning comparable large developed and undeveloped acreages of natural resources properties having oil and gas potentials and (3) as to the effect of inflation on the market values of such properties (Tr. 10030; Com. Ex. 146). Some of this testimony pointed out basic fallacies and errors made by Morgan, Stanley & Co. in its report on which it had based its recommendation of merger terms (Tr. 9910-15). These errors had resulted in an understatement of the value of the Northern Pacific's natural resources properties, but even so, as noted above, the recommendation set a premium on the value of Northern Pacific stock over that of Great Northern stock.

The Committee also offered a detailed proposal providing for the segregation and offer for sale to Northern Pacific stockholders, prior to merger, of these natural resources properties and the substitution of cash therefor in the hands of the new railroad company.

The applicants offered no expert testimony or other evidence to rebut the direct case of the Committee as to the valuation of these natural resources properties.

The hearings before the examiner were closed on July 10, 1962, and in 1964 the examiner submitted a report recommending approval of the merger on the stock exchange ratios proposed.

The Committee's petition for a further hearing, served and filed in June 1963, was denied by an order of the Commission, Division 3, dated July 19, 1963.

The Commission in its first report and order, dated March 31, 1966 (328 I.C.C. 460, J. App. 61-244), disapproved the proposed merger by a 6 to 5 vote on the ground that it was not consistent with the public in-

terest. This decision did not discuss the matter of the stock exchange ratios.

In July 1966, the Committee served and filed a petition for further hearing seeking to update the record with evidence as to the justice and reasonableness of the proposed merger terms and seeking reconsideration in certain respects, which petition was denied by an order of the Commission on January 4, 1967.

The Commission in its first report and order on reconsideration dated November 30, 1967 (331 I.C.C. 228, J. App. 245-462) approved the proposed merger by a vote of 8 to 2 and substantially adopted its examiner's finding approving the justice and reasonableness of the stock exchange ratios.

The Committee on January 11, 1968 filed a petition for reconsideration and for further hearing on the ground that the record should be updated, particularly as to the valuations of the natural resources properties of Northern Pacific. This petition was denied by the Commission in its second report on reconsideration dated April 11, 1968 (331 I.C.C. 869, J. App. 463-497), which report also corrected a misstatement as to the Committee's proposed condition involving segregation through a new land company.

The Committee then on May 6, 1968 commenced an action in the United States District Court for the Southern District of New York to suspend, annul, enjoin and set aside the orders of the Commission and for injunctive relief, which relief was denied.

After the commencement of a similar action by the Department of Justice of the United States in the United States District Court for the District of Columbia, the Committee consented to the stay of its

action in the New York court and intervened in the action in the District of Columbia, by filing a complaint similar to the one previously filed in New York. This was heard before a three-judge district court on application for a stay and on final hearing. Said court on November 20, 1968 entered an order dismissing appellants' complaint and denying the prayers therein. In substance the District Court reviewed the findings of the Commission and, on the basis of the record upon which the Commission had relied, sustained the Commission's ultimate finding that the stock exchange ratios were just and reasonable. The court also refused to require the Commission to reopen the record to update it.

This appeal followed.

SUMMARY OF ARGUMENT

The stock exchange ratios giving Great Northern stockholders more stock in the New Company than Northern Pacific stockholders cannot be justified on the present record. This injustice, initiated nine years ago when the merger terms were agreed upon, stands out even more starkly in view of the evidence of current material facts which the Commission has refused to admit into the record. As of 1969, Northern Pacific's net income exceeds Great Northern's; so does the price of its stock on the stock exchange, this latter in spite of lower dividends and the fact that only a possible decision of the Court can prevent consummation of the merger on the present terms. In the past decade the trend to new all-time highs in gross revenues from Northern Pacific's natural resources properties has continued and Northern Pacific's net worth per share is now greater than Great Northern's. And

perhaps of even more significance than all these facts together, radically changed economic and inflationary conditions since 1960 have had a highly favorable effect on land and natural resources properties as a form of capital investment. Yet under the proposed merger terms Northern Pacific stockholders will probably not even achieve *parity* with Great Northern stockholders for 30 years after consummation of the merger.

According to computations based on net income for the latest year available, 1968, and testimony in the record of *Great Northern's* financial consultant as to appropriate price-earnings ratios, each Northern Pacific stockholder should receive 1.313 shares of the New Company's stock for every 1 such share to be received by each Great Northern stockholder with no provision for any preferred stock (App. VII, Sch. 3, *infra*). On the Committee's unrebutted expert testimony this ratio should be even higher, to wit, 1.910 to 1 (App. VII, Sch. 2, *infra*).

The novel valuation problem presented by the ownership by only one of the parties to the merger of vast natural resources properties, differing radically from railroad properties, has not been faced up to by the applicants, the Commission and the District Court. The record contains no testimony of any experts offered by applicants as to the market value of these natural resources assets or as to appropriate price-earnings ratios to be applied to the earnings therefrom. Nowhere do the applicants correlate and weigh the contributions of the various groups of stockholders in determining just stock exchange ratios.

The Commission failed to make an independent determination of proper stock exchange ratios or to state

with any precision a rational basis for its ultimate finding, erroneously relying primarily on alleged arms length bargaining of the parties and also on the affirmative votes of stockholders.

The Commission also failed to consider and review the whole record and particularly the extensive, material, expert, unrebutted testimony offered by the Committee as to various factors necessary to be considered in the valuation of the contribution being made by Northern Pacific stockholders in the merger. Nor did it consider and review the precise inequities of the proposed merger terms, which inequities the Committee pointed out basing its calculations entirely on evidence in the record.

The Commission and the District Court have misinterpreted and misapplied the requirements of Section 5(2) of the Interstate Commerce Act by accepting the judgment of, and the results of negotiations by, the applicants and the votes of stockholders as decisive of the justice and reasonableness of the merger terms.

The District Court apparently accorded to the Commission an expertise in its finding as to the value of non-railroad properties not intended to be granted by Congress in the enactment of Section 5(2) of the Interstate Commerce Act.

In addition, the Commission totally abused its discretion and violated due process in denying the Committee's petition in 1968 for further hearing to receive evidence of the current worth of the contributions being made by the various groups of stockholders in view of radical changes in the relative earnings of the applicants and in the national economy, both of which vitally affect the justice and reasonableness of merger

terms negotiated in 1960 and supported by a record closed in July 1962.

This error is critical in this case and disastrous to the interests of Northern Pacific stockholders since as a matter of law as well as justice the values of the contributions being made by the various groups of stockholders must be determined as nearly as possible to the date of the possible consummation of the merger in 1969 or 1970—not on evidence existing when the merger terms were agreed upon in 1960 or when the hearings closed in 1962. This denial contrasts sharply with the action of the Commission in allowing a further hearing in 1967 to update the record as to the estimated savings that might be realized from a merger of *railroad* properties and operations as to which there had been no fundamental changes.

The record also does not sustain the Commission's arbitrary finding that the Committee's proposed condition, involving the segregation and offer for sale to its stockholders prior to merger of Northern Pacific's natural resources properties to a new land company, was without merit and unfair to Northern Pacific stockholders. Although the Commission finally corrected its examiner's and its own misstatement of the plain terms of the proposed condition, it failed to correct its erroneous conclusion based thereon. Early in their negotiations applicant had without success sought a plan to segregate these properties. Adoption of this condition could equitably achieve such a result without the necessity of renegotiation of the proposed merger terms.

ARGUMENT

INTRODUCTION

This is no mere railroad merger. This case is unique on its facts in that only one of the common carriers involved in the consolidation, to wit, Northern Pacific, has surface rights as well as timber, oil and gas, and other mineral interests in a vast acreage.

This case is also novel in the legal problem which it presented to the Commission and the District Court and which it presents here: How to value these natural resources properties, both income producing and unexplored, in arriving at just and reasonable stock exchange ratios. This unique aspect of the case on appeal takes on an added public importance when viewed against the background of the present maneuverings (both offensive and defensive) of corporate conglomerates involving railroads, airlines and public utilities subject to the regulation of various Federal agencies.

This legal problem, necessarily involved in the determination of just and reasonable stock exchange ratios, mandated by Section 5 of the Interstate Commerce Act, has been evaded and sidestepped by the applicants, the Commission and the District Court largely on the ground of difficulty of the valuations involved.

I. THE RECORD DOES NOT CONTAIN SUBSTANTIAL EVIDENCE TO SUPPORT THE FINDING OF THE COMMISSION AND THE DISTRICT COURT THAT THE PROPOSED STOCK EXCHANGE RATIOS ARE JUST AND REASONABLE.

Basic Law

The Interstate Commerce Act requires the Commission, before approving a railroad consolidation, to find that the terms of merger are just and reasonable to all parties. Section 5(2)(b) of the Interstate Commerce Act, 49 U.S.C. 5(b); *Schwabacher* v. *United*

States, 334 U.S. 182; *Cleveland, Cincinnati, Chicago & St. Louis Railway Company* v. *Jackson*, 22 F. 2d 509 (6th Cir. 1927).

The statutory test is broad—that the merger terms must be "just and reasonable".

Section 5(2)(b) provides in pertinent part as follows:

> "If the Commission finds that, subject to such terms and conditions and such modifications as it shall find to be just and reasonable, the proposed transaction is within the scope of subdivision (a) of this paragraph . . ., it shall enter an order approving and authorizing such transaction, upon the terms and conditions, and with the modifications, so found to be just and reasonable . . . ."

In the *Schwabacher* case, *supra*, the Court said at page 200:

> "Federal law requires that merger terms be just and reasonable to all groups of stockholders, in contemplation of the continued use of their capital in the public calling to which it has been dedicated."

In the same case the Court also said at pages 199 and 201:

> "In appraising a stockholder's position in a merger as to justice and reasonableness, it is not the promise that a charter made to him but the *current* worth of that promise that governs, it is not what he once put into a constituent company but what value he *is contributing* to the merger that is to be made good . . . .
>
> "In making that determination, those rights are to be considered to the extent that they may affect *intrinsic or market values.*" (Emphasis supplied)

Valuation Problem

The difficulty of determining just and reasonable merger terms in this case arises from the fact that whereas both Northern Pacific and Great Northern are contributing railroad properties to the New Company, only Northern Pacific is contributing vast natural resources properties. These are disparate in character from railroad properties which are not readily marketable (Tr. 117-8). Natural resources properties are "explosive" in that new discoveries and new techniques of discovery can reveal latent values (Tr. 9894-5). Railroad properties are valued primarily on the basis of capitalization of earnings (Tr. 10022). Natural resources properties are valued by asset appraisals and by capitalization of current earnings, in which latter case a higher price-earnings ratio is applied to allow for future increased earnings potential (Tr. 9999-10000). In either case, with natural resources many factors must be considered which are not applicable in valuation of railroad properties (Tr. 9918-22). How to compare, reconcile and weigh on the scales of justice the values of such radically different kinds of properties in measuring the contributions of each group of stockholders is the nub of the problem. This has so far successfully been avoided in this case by the applicants, the Commission and the District Court.

Burden of Proof

5 U.S.C. 556(d) places the burden of proof in an administrative proceeding upon the proponent of an agency order and provides that an agency order may not be "issued except on consideration of the whole record or those parts cited by a party and supported by and in accordance with the *reliable, probative and substantial evidence.*" (Emphasis supplied)

In *Louisville & Nashville Railroad Co. Merger*, 295 I.C.C. 457, 505 (1957) the Commission stated:

> "As in all applications filed under Section 5(2) of the act, the burden of proof is on the applicants herein, and it is their responsibility to decide at their own risk, the nature and kind of evidence to be presented in support of the application."

Nature and Kind of Evidence Put in Record by Applicants

What was the evidence which the applicants put in the record and which they considered reliable, probative and substantial to support the stock exchange ratios agreed on?

The testimony of Mr. Macfarlane, President of Northern Pacific and its chief negotiator, outlined the course of negotiations resulting in agreement on merger terms in June 1960 after both parties had obtained from timber and oil experts unsworn appraisal reports in 1958 and 1959 concerning Northern Pacific's natural resources properties (Tr. 87-101).

Over objection (Tr. 91-3) Mr. Macfarlane testified as to valuation figures in these reports not then in evidence or intended to be offered in evidence (Tr. 91-2), stating that some of these figures were "in excess of what these properties would sell for" (Tr. 93-4). He also testified as to a "judgment figure" of Morgan, Stanley & Co. (Northern Pacific's financial advisor) as to the value of the nonrail properties arrived at "after considering the reports . . . and after using various methods of valuation and taking into account taxes and depletion" (Tr. 96). Mr. Macfarlane testified as to Morgan Stanley's recommendation in May 1959 that Northern Pacific should not merge at all unless Northern Pacific stockholders received in the stock exchange

ratios a minimum of slightly better than a share for share exchange (without any provision for preferred stock) (Tr. 96; Com. Ex. 32, p. 28). Later, on cross-examination, both Mr. Macfarlane and Mr. Payne for Morgan Stanley, testified that acceptance in June 1960 of final merger terms, worse for Northern Pacific stockholders, was not based on any worsening of its situation in relation to Great Northern's (Tr. 1176, 2472). As to final merger terms, Mr. Macfarlane testified: "Finally on June 2, 1960, Mr. Budd and I, with the advice of our financial consultants, agreed . . . ." and that this basis of agreement was "arrived at by arms-length bargaining" (Tr. 101).

Instead of offering the testimony of expert witnesses familiar with the value of the surface rights and the timber, oil and gas and other minerals, and calculations based thereon, to support any stock exchange ratios the applicants rested their case on Mr. Macfarlane's testimony (1) that "A definitive valuation of either Northern Pacific or Great Northern stock, except on the basis of capitalization of earnings, is difficult if not impossible to make . . . ." (Tr. 117); (2) that "The attempt to arrive at comparative values of the two stocks by separately valuing the natural resource properties of the Northern Pacific and developing a ratio of Northern Pacific stock without those properties to Great Northern stock proved impractical because of inability to agree on the correct ratio and because of the difficulty of arriving at a valuation of the natural resources which could be regarded as fair to both sets of stockholders . . . ." (Tr. 118); and (3) that "In the last analysis the determination of a fair and equitable ratio had to be a matter of judgment based on a consideration of *all factors* including a realistic ap-

praisal of what terms would be necessary to bring about acceptance by both sets of stockholders" (Tr. 118-9, emphasis supplied).

Although it was not specified what "all factors" were, Mr. Macfarlane in a dreary litany of the prospects of the company over which he presided cited only the following factors, all favorable to Great Northern: (1) Great Northern historically had higher earnings and there was nothing reasonably foreseeable to indicate that Northern Pacific's future earnings prospects were better than Great Northern's, (2) Great Northern was better equipped to maintain itself in intermodal transportation competition, and (3) Great Northern historically had a higher dividend rate, the stock commanded a higher price on the market and the dividend on the preferred shares in the New Company to be distributed only to Great Northern shareholders "will come out of earnings of the consolidated company contributed in greater part by the Great Northern" (Tr. 119-121).*

As to applicants' testimony that the alleged bargaining was at arms length, it should be kept in mind that these two managements had jointly owned, controlled and operated the Burlington since the turn of the century and their heads alternated as president of the equally owned Spokane, Portland and Seattle Railway Company. Their offices were in the same block in St. Paul, Minnesota, and both had been presidents of their respective railroads since 1951 (Tr. 52, 154, 985).

On their direct case applicants' witnesses testified frankly that in negotiating the merger terms the chief negotiators felt themselves "under extreme compul-

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* See below pp. 40 to 45.

sion" to achieve a consolidation of their railroad properties and that this was "the overriding consideration" in the merger application (Tr. 144-7; 176). We suggest there was no necessity on the part of the mangement of Northern Pacific to conclude any bargain except on terms which fairly reflected the current worth of its natural resources properties.

Mr. Payne, the only witness of Morgan, Stanley & Co., Northern Pacific's financial advisor, testified (1) that his other partners were more active in the preparation of the firm's report on the non-railroad properties of Northern Pacific (Tr. 2393); (2) that he was not qualified to testify as to how important a new oil discovery was (Tr. 2451-2); (3) that he was doubtful about the true legal test for determining fair merger terms (Tr. 2442-3); (4) that Morgan Stanley had not computed the tax benefits from depletion allowances on the natural resources of Northern Pacific which admittedly might run into millions of dollars (Tr. 2490-2); and (5) that the calculations on which Morgan Stanley's recommendation of stock exchange ratios in May 1959 was based were not reworked when their advice was sought as to final merger terms agreed on in June 1960 (Tr. 2472-3).

Mr. Dobson, the only witness for First Boston Corporation, financial advisor to the Great Northern, admitted that they gave no consideration to asset valuation of Northern Pacific's natural resources properties, and that First Boston believed as a matter of pure judgment that the price earnings ratio to be applied to natural resource income should be 1½ times the ratio to be applied to railroad income (Tr. 2582; 2574-5).

In summary, the applicants' case in the record is that the proposed stock exchange ratios were the result of negotiations between persons with short arms acting under extreme compulsion to achieve a merger of railroad properties; that no attempt was made to determine asset valuations of the valuable natural resources properties which the Northern Pacific stockholders are contributing to the New Company because of the difficulty of valuation and the inability to agree on a correct ratio; and that it had to be a matter of judgment. The record contains no explanation as to how the differences as to current worth of the railroad properties and/or natural resources properties were resolved or related, one to another, in arriving at the final stock exchange ratios.

The applicants thus failed to carry the burden of proving by reliable, probative and substantial evidence of the justice and reasonableness of the stock exchange ratios as required by 5 U.S.C. 556(d).

Such testimony of railroad officials and financial advisors unsupported by expert testimony as to values of the natural resources was not worthy of reliance as evidence of the current worth of what Northern Pacific stockholders are contributing. Nor was it probative in the sense of serving to prove such current worth. In striking contrast, the applicants offered the testimony of many experts on the many facets of the railroad side of this case to support their estimates of savings to be achieved through merger and their claim of better transportation service.

It may be that valuation is difficult and cannot be expected to be precise in dollars but "good" alibis are poor substitutes for reliable supporting evidence in administrative and judicial proceedings.

Duty of the Commission

Under 5 U.S.C. 556(d) the Commission may not enter an order except on a record supported by and in accordance with "reliable, probative and substantial evidence". As shown above, its ultimate finding in this case that the record is both "adequate and affirmative" (J. App. 297) is not supported by such evidence. Moreover, the Commission's duty in every case under Section 5(2) of the Interstate Commerce Act is to make an *independent* determination of what terms and conditions are just and reasonable.

An application for approval under that section always follows an agreement on merger terms—presumably made in every case as a result of arms length bargaining. So, it is not surprising that Section 5(2) does not mandate arms length bargaining as to merger terms as a test required before Commission approval —as erroneously stated by the Commission in its opinion (J. App. 297). If the Commission were not duty-bound to make an independent determination of merger terms that were just and reasonable, the Congressional intent of requiring Commission approval would be meaningless as to this matter. Cf. *Case* v. *Los Angeles Lumber Products Co. Ltd.*, 308 U.S. 106, 128-9, where what the Court said about the necessity of an independent determination in a Section 77 reorganization case seems equally pertinent to the responsibilities of the I.C.C. here:

> "If the reorganization court were bound by such conventions of the parties, it would be effectively ousted of important duties which the Act places on it. Federal courts acting under Sec. 77B would be required to place their imprimatur on plans of reorganization which disposed of the assets of a company not in accord with the standards of

> 'fair and equitable' but in compliance with agreements which the required percentages of security holders had previously made. Such procedure would deprive scattered and unorganized security holders of the protection which the Congress had provided them under Sec. 77B. The scope of the duties and powers of the Court would be delimited by the bargain which reorganizers had been able to make with security holders before they asked the intercession of the Court in effectuating their plan."

Here the Commission has not made any such independent determination. It certainly has not made any supporting findings of the values of the current worth of what each group of stockholders is contributing in the merger (particularly as to Northern Pacific's natural resources properties). Nor has it made or required any reasoned analysis or explanation of how the stock exchange ratios it has approved where determined in the first instance. For a strong contrast to the void in the present record see the detailed supporting stock ratio calculations and discussions based on the record of the Commission's examiner at pages 109-155 in his report in the *Norfolk and Western-Chesapeake and Ohio Merger,* dated March 20, 1969 (Finance Docket # 23832).

5 U.S.C. 557(c) relating to administrative agencies provides in pertinent part as follows:

> ". . . All decisions . . . are a part of the record and shall include a statement of (A) findings and conclusions, and the reasons or basis therefor, on all material issues of fact, law or discretion presented on the record; . . ."

Perhaps the comments in *Soo Line Railroad Company* v. *United States,* 280 F. Supp. 907 (D. Minn.

1968), at pages 919 and 921, which involved the question of evidence of traffic diversion, best describes the duties of the Commission in this *Northern Lines* case:

> "We fully understand that the task of the Commission in determining potential diversion is a difficult and complex one, and that future events may prove that the Commission's findings were wide of the mark. But the very fact that these are difficult and complex matters makes it all the more necessary for the Commission to use its expertise, but use it it must.
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> * * * * *
>
> "We recognize the difficulty in making these determinations and the natural inclination to escape them by avoiding specific findings and leaving as many issues to negotiation between the parties as possible. When this is done, however, effective judicial review is impossible."

What are "just and reasonable" merger terms must be grounded on evidence that a court can conscientiously find to be substantial and appealing to a reasonable mind. *Universal Camera Corp.* v. *National Labor Relations Board,* 340 U.S. 474; *Interstate Motor Freight System* v. *U. S.,* 243 F. Supp. 868 (W.D. Mich. 1965). The Commission has contented itself here with the wholly conclusionary finding that the merger terms as proposed by the parties "fairly reflect the contributions of each group of stockholders to the combined system" (J. App. 297).

The duty of the Commission was recently clearly stated in *Florida East Coast Railway Company* v. *U. S.,* 259 F. Supp. 993 (M.D. Fla. 1966) at pages 999-1000:

> "If judicial review is to have a basis for functioning, the ICC must do more than announce its

ultimate conclusions by way of unrationalized fiat. *The Commission must explain its reasoning in clear and precise terms. It must support its application of that reasoning to the instant case by substantial evidence in the record on which we must base our review.*" (Emphasis supplied)

The Commission has nowhere in its decision indicated that it has considered the many factors peculiarly applicable to natural resources properties in its conclusionary finding that the stock exchange ratios are just and reasonable. In *Schwabacher* v. *U. S., supra,* at 201, the Court ordered a remand to the Commission merely because "it [Commission] may have declined to consider" only one factor, rights of preferred stockholders based on state statutes. Here the Commission without specifying the "many factors" involved relied chiefly on "past earnings" and past "dividends", and what terms were "necessary to bring about acceptance by both sets of stockholders" and stockholders' votes (J. App. 292, 465).

It required, and the record contains, no expert asset valuation, tested by cross-examination, as to what these natural resources properties would be worth in the market place in dealings between parties free of compulsion. Nor does the record contain direct testimony by any expert offered by the applicants as to what price earnings ratio would be appropriate if capitalization of earnings of natural resources were to be employed as a method of valuation.

In the *Louisville & Nashville R. Co. Merger,* 295 I.C.C. 457, the Commission specified eighteen factors applicable to the valuation of railroad properties alone. Here we are left in total ignorance of any of the factors found by the Commission to be applicable to the

proper valuation of the Northern Pacific's natural resources properties, which factors, presumably, undergirded the Commission's ultimate finding that the stock exchange ratios were just and reasonable. The Commission cited only two cases in support of this finding: *Erie R. Co. Merger,* 312 I.C.C. 185, and (of all choices) *Louisville & Nashville R. Co. Merger, supra.* Neither, of course, are decisive of the issue in this case since both involved only railroad properties.

In short, the Commission has signally failed to discharge its duty in this case and presents a record without substantial evidence to support its ultimate finding as to stock exchange ratios. The record is wholly inadequate to enable a reviewing court intelligently to pass on the merits of the case and was stale, inadequate and incomplete on important matters at the time it rendered its final decision.

II. IN FINDING THE STOCK EXCHANGE RATIOS TO BE JUST AND REASONABLE THE COMMISSION AND THE DISTRICT COURT ERRED IN FAILING TO CONSIDER AND REVIEW THE WHOLE RECORD OR THOSE PARTS THEREOF CITED BY THE COMMITTEE. ON THE BASIS OF THE WHOLE RECORD THERE IS NO SUBSTANTIAL EVIDENCE TO SUPPORT THEIR FINDING.

Statutes and Cases

5 U.S.C. 556(d) relating to administrative agencies provides in pertinent part:

> "* * * A sanction may not be imposed or rule or order issued except on consideration of the whole record or those parts thereof cited by a party . . . ."

5 U.S.C. 706 relating to judicial review provides in pertinent part:

> "To the extent necessary to decision and when presented, the reviewing court shall decide all rele-

> vant questions of law, interpret constitutional and statutory provisions, and determine the meaning or applicability of the terms of an agency action * * * In making the foregoing determinations, the court shall review the whole record or those parts of it cited by a party, and due account shall be taken of the rule of prejudicial error."

In *Universal Camera Corp.* v. *National Labor Relations Board, supra,* at page 488 the Court said:

> "Congress has merely made it clear that a reviewing court is not barred from setting aside a Board decision when it cannot conscientiously find that the evidence supporting that decision is substantial, *when viewed in the light that the record in its entirety furnishes, including the body of evidence opposed to the Board's view.*" (Emphasis supplied)

And in *Interstate Motor Freight System* v. *U. S., supra,* at page 871 the Court said:

> "However, this does not mean that it is merely the function of the courts to search the records for evidence which in and of itself justifies the administrative decision. 'Substantial evidence' must be determined *with a full consideration of contradictory evidence,* or evidence from which conflicting inferences could be drawn." (Emphasis supplied)

The Committee's evidence in the record has not been fully considered by the Commission and reviewed by the District Court. Had it been, they could not reasonably have found the proposed stock exchange ratios ***just and reasonable.***

Throughout the entire proceeding before the Commission, the Committee has been constantly mindful

of the criticism leveled at a group of stockholders, in *Erie Railroad Company Merger,* 312 I.C.C. 185 (1960), who were questioning the justice and reasonableness of the stock exchange ratios. They had presented no witnesses and had offered no positive evidence. In that case at page 242, the Commission stated:

> "Neither the record nor any pleading presented by the dissenters offers any suggestion of *precise inequities* of the agreed plan, and *no alternative plans* are submitted for the guidance and consideration of the Commission.
>
> * * * * *
>
> "No attempt is made to refute the various criteria, outlined hereinabove, which the applicants present in support of the conclusions regarding the appropriate relationships between the value to the unified company of the contributions which the Erie and Lackawanna would offer." (Emphasis supplied)

In this case the Committee has done both. It has also put in the record positive evidence of expert witnesses and numerous exhibits relating to the valuation of the natural resources properties of Northern Pacific. It has not had funds sufficient to discharge the *applicants' duty* to produce expert valuations of the natural resources properties although it has been *criticized by the applicants,* and inferentially by the Commission, for not coming "forward with any definitive valuations" (J. App. 296).

Committee's Evidence

A brief summary of the substance of the Committee's evidence is necessary if the nature, extent and materiality of it is to be appreciated, particularly as it has largely been ignored in the decisions of the Commission and in the opinion below.

The Committee's witnesses, Brundage, Story and Williams, were all experts in valuing stocks as life-long investment counsel. Keplinger was an eminent oil geologist particularly familiar with the Williston Basin, and Sutton was an expert on underwriting oil and gas issues.

Mr. Brundage testified to various fallacies in valuation methods in the Morgan, Stanley & Co. report on the non-railroad operations of Northern Pacific (Com. Ex. 32, Tr. 9911-5). Although it recommended a stock exchange ratio favoring Northern Pacific stockholders, with their erroneous assumptions and calculations Morgan Stanley still denigrated the contribution of Northern Pacific stockholders consisting in part of their natural resources properties. More importantly, Mr. Brundage pointed out the factors, significantly different from those involved in valuing railroad properties, that must be considered in valuing natural resources properties. The most important of these are: the quality of the earning power of such assets; the low risk involved; the high return on invested capital; the large tax depletion allowances; the growth factors and future potentials; the stability of earnings (particularly from timber) compared to railroad earnings; the fundamental strategic, intrinsic and survival values of land holdings and the favorable prospects for the utilization of Northern Pacific lands in the near future (Tr. 9918-22).

Mr. Story testified in 1962 as to the trends in prices of natural resources and their value as a hedge against past and probable future monetary inflation. Mr. Williams testified as to the high market values of developed and undeveloped land, basing his testimony on the high price-earnings ratios prevalent in the market place with reference to then recent sales of stock

of comparable companies having large land aggregates (Tr. 9894-5; 9916-22; Com. Exs. 146 and 147; Com. Ex. 145, Parts C and D; Tr. 9887, 9935; 9983-10,000).

Mr. Keplinger, the oil geologist, testified in 1962 that more than 5½ million acres of Northern Pacific lands were favorable to discovery of oil and gas. In his expert opinion the youth of the exploration effort, the lack of deep zone explorations, the high ratio of discovery wells, the likelihood of concentrated exploration, the prospect of more pipelines, the irreplaceability at any price of such a land aggregate having oil and gas potentials, active leasing, and likely increases in price of oil and favorable secondary recoveries made the railroads' valuation of these lands extremely conservative (Tr. 10060-71).

Mr. Sutton testified as to the feasibility of the Committee's proposal for a new land company from an underwriting point of view (Tr. 10054).

The Committee also put in evidence all of the various unsworn appraisal reports of Northern Pacific's natural resources properties (except one previously offered by the Board of Railroad Commissioners of the State of Montana), the reports of the financial advisor to the Northern Pacific and other statistical and evidentiary exhibits (Com. Exs. 24, 25, 29, 30, 31, 32, 33, 145, 146, 147, and 148). Unreliable and down-grading as these reports are,* the values stated in them re-

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*Mr. Macfarlane, Chairman of the Consolidation Committee of Northern Pacific, stated in May 1959 that he believed the Morgan Stanley report allowed a "wholly inadequate amount for Northern Pacific's natural resources" (Com. Ex. 145, Part I).

Both Mr. Macfarlane and the Witness for Morgan, Stanley & Co. testified that there had been no deterioration of Northern Pacific's situation in relation to Great Northern's between May of 1959 and June of 1960 (Tr. 1176, 2472).

sult in stock exchange ratios favoring Northern Pacific stockholders (App. II, Sch. 4, *infra*; App. VII, Sch. 4, *infra*).

The applicants nowhere in the record offered any expert or statistical or other evidence to rebut this extensive direct case of the Committee; nor did they offer any evidence of asset valuation, "definitive" or otherwise, of the natural resources properties of Northern Pacific. Thus, this case is not the usual one in which two sides offer expert witnesses who differ widely on their land appraisals and a finding of value favoring one side, or in the middle, is made.

The Committee also submitted what it deemed to be a constructive proposed condition to achieve segregation of Northern Pacific's natural resources properties prior to consummation of a merger of railroad properties *without requiring a renegotiation of stock exchange ratios.**

Committee's Calculations Based on Record

Finally, the Committee was precise in its criticism of the stock exchange ratios when its Chairman, Charles E. Brundage, testified that it would be unfair to require Northern Pacific stockholders to contribute their natural resources properties to the New Company unless they received in exchange a *minimum* of one and a half (1½) shares of stock of the New Company for every one (1) such share received by Great Northern stockholders with no provision for any preferred stock (Tr. 9925).

The Committee was, and is, even more precise in calculating on three different bases what the ranges

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* See below, pp. 51 to 55.

of stock exchange ratios would be, *based on testimony and facts entirely of record.* These calculations were included in an appendix annexed to the Committee's Exceptions to the original examiner's report and are annexed hereto as Appendix II.

We believe that a careful study of the range of stock exchange ratios resulting from these calculations reveals the grave injustice that Northern Pacific stockholders will suffer if the proposed merger terms are approved.

All of these calculations are based on capitalization of *transportation* earnings at the only price-earnings ratio in the record, fifteen (Tr. 10022), as to which no rebuttal evidence was offered and no exception has at any time been taken by the applicants.

The first calculation, Schedule 2 of the annexed Appendix II, capitalizes Northern Pacific's *natural resources* net income at fifty times earnings. This is supported by the record including all the Committee's direct case evidence and especially by that of Mr. Williams (Tr. 10000-1). The resulting stock ratios closely approximate that suggested by the Committee as fair (Tr. 9925).

The second calculations, Schedule 3, of the annexed Appendix II, is based on the *Great Northern's* financial advisor's testimony that natural resources earnings should be weighted at 1½ times transportation earnings, or a price-earnings ratio of 22½ (Tr. 2572, 2574-5). That this ratio is extremely low becomes apparent when it is compared with the price-earnings ratios for all categories of natural resources properties ranging from a low of 18.2 to a high of 257.1 for the most comparable companies which Morgan, Stanley

& Co. could find, and which appear in the right hand column of Exhibit I annexed to its report (Com. Ex. 32).

The third calculation, Schedule 4 of the annexed Appendix II, is based on asset or appraisal valuations summarized of record (Com. Ex. 32, p. 19), after elimination of industrial properties, but without taking into consideration the Committee's evidence showing the fallacies and false assumptions made in the Morgan, Stanley & Co. report (Com. Ex. 32, Tr. 9913-6).

These calculations demonstrate with precision not only the injustice of the proposed stock exchange ratios to Northern Pacific stockholders, but, the extent thereof, although this burden of proof as a matter of law does not rest on the Committee as an intervenor.

Applicants' Admissions

On cross-examination of the negotiators and of their financial advisors it developed that they had assumed in those negotiations that the future trend of prices of timber and oil would remain stable, unaffected by inflationary factors as to which the Committee's witnesses had testified (Com. Exs. 146 and 147; Tr. 10067-8; 9922). Mr. Macfarlane testified he was quite content to have Northern Pacific stockholders assume the risk of substantial monetary inflation (Tr. 1040) and in the negotiations he did not "take into account the integrity of our American dollar" (Tr. 1042). Mr. Budd, for Great Northern, testified that in the negotiation of merger terms he considered monetary inflation in the valuation of the natural resources to "a very small degree" (Tr. 1421-2). Both of the financial advisors had no knowledge of the trend of prices of timber and oil (Tr. 2455-7; 2563).

Errors of Commission and District Court

Neither the decisions of the Commission nor the opinion of the District Court at any place discuss, evaluate or explain away the extensive, material, expert, contradictory, unrebutted testimony of the Committee's witnesses as to various factors, including inflation, peculiarly applicable in the valuation of natural resources properties, comparative sales as a basis of price-earnings ratios, and the Committee's calculations of appropriate stock exchange ratios based entirely on the record. This testimony has simply been ignored.

The trend of comparative net incomes of Northern Pacific and Great Northern (an important factor on any basis of valuation), of record through 1961, reflecting the increasing earnings from Northern Pacific's natural resources properties after the discovery of oil in the Williston Basin (Tr. 2552), summarized in Appendix IV hereto, is nowhere commented on or considered in any of the Commission's decisions.

The Commission's criteria of judging the justice of merger terms were largely (1) so-called arms length bargaining and (2) the votes of groups of stockholders. These are not criteria derived from Section 5(2)(b) of the Interstate Commerce Act. As to the former, the courts have expressly stated that arms length bargaining is not a decisive criterion. Cf. *In re North American Light & Power Co.*, 170 F. 2d 924 (3d Cir. 1948). There is nothing in Section 5(2)(b) to sustain the Commission's statement (J. App. 297) that arms length bargaining was one of the "required tests". As to the latter, the only reference in Section 5 to the requirement of a favorable vote of stockholders is in Section 5(11) which makes such a vote necessary before

the applicants "shall have full power . . . to carry such transaction into effect".

The Commission in its Second Report on Reconsideration (J. App. 471) states the very misleading statistic that 96.6% *of the votes cast* by Northern Pacific stockholders supported the merger terms. Actually they were approved by only 73.2% of all stockholders entitled to vote, after a contest in which the opposition sought—not a negative vote—but *no vote at all*. A swing of slightly more than 3% would have defeated the merger in spite of the possibility of many advantages from a merger of *railroad* operations.

What managements of corporations are willing to agree to (in this case under extreme compulsion to achieve a consolidation of *railroad* properties and operations) and what they can "sell" to many inadequately informed, unsophisticated and apathetic stockholders is not the statutory measure of the duty of the Commission under Section 5(2) to make an independent determination of just merger terms based on an adequate, reliable and current record.

As was the case with the Commission, the District Court adopted the erroneous interpretations of Section 5(2) of the Interstate Commerce Act just discussed herein. It relied on "prolonged discussions", approvals of merger terms by financial consultants, directors, stockholders, and "arms length bargaining as evidence of fairness" and sustained the conclusion of the Commission "that the ratio reflected fairly the contributions of each group of stockholders to the combined system" without any references to the record (J. App. 45).

What the court below failed to do, as required by 5 U.S.C. 706, was to review those parts of the record

made and cited by the Committee which dealt particularly with the valuation of the natural resources properties of Northern Pacific. It advanced no theory of valuation which it deemed to be proper under Section 5(2) or any method or basis on which the values of railroad and non-railroad properties being contributed in the merger could be reconciled or weighed in determining just and reasonable stock exchange ratios.

The District Court misapprehended and misstated the Committee's position on the matter of valuation (J. App. 45). The record shows that it was not the Committee but was Mr. Macfarlane, chief negotiator for Northern Pacific, who testified that "A definitive valuation of either Northern Pacific or Great Northern stock, except on the basis of capitalization of earnings, is difficult if not impossible to make. . . ." (Tr. 117).

Aware of the difficulties of an *exact* appraisal in dollars, the Committee has always insisted on the necessity of valuation of the natural resources properties, if there is to be reliable and substantial evidence in the record to support any finding as to just and reasonable stock exchange ratios. And, as the Commission recognized in its 1967 Report on Reconsideration, the Committee has consistently taken the position that the natural resources properties were gravely underrated by the negotiators in arriving at the proposed merger terms (J. App. 294).

The District Court also appears to have erred as to its true function and authority on judicial review as to the stock exchange ratios. In its opinion (J. App. 46) the court stated:

> ". . . we think all significant issues regarding the ratio were fully considered and decided in a man-

> ner which requires the court to withhold any direction of its own that the ratio should be different."

The function of the court in the posture in which it found itself was clearly to remand if it found the Commission's finding as to ratios not supported by substantial evidence—not to redetermine the same. This may not have been an inconsequential error in arriving at its decision to approve the Commission's action in view of the difficulties necessarily involved in this case in calculating just and reasonable stock exchange ratios which determination it also undoubtedly wished to avoid.

The District Court further erred in not giving particular attention to the special factors involved in valuation of Northern Pacific's natural resources properties in view of the lack of expertise of the Commission as to non-railroad properties and in view of the explicit and detailed Committee evidence concerning these factors. We suggest Congress in 5 U.S.C. 706 placed limits on the scope of judicial review precisely because it recognized the *particularized* experience of the administrative agencies, including the Commission's experience in *transportation* matters.

In summary, on this record the Commission and the District Court have not complied with the mandates of 5 U.S.C. 557(c) and 5 U.S.C. 706 and there is no substantial evidence in the record, considered as a whole, to support their finding that the proposed stock exchange ratios are just and reasonable.

III. THE COMMISSION ABUSED ITS DISCRETION AND VIOLATED DUE PROCESS IN DENYING THE COMMITTEE'S PETITION FOR FURTHER HEARING IN 1968 TO RECEIVE EVIDENCE OF THE CURRENT WORTH OF THE CONTRIBUTIONS BEING MADE BY THE VARIOUS GROUPS OF STOCKHOLDERS. THE DISTRICT COURT ERRED IN AFFIRMING THIS DECISION.

Introduction

The merger terms herein were agreed upon in 1960 and the record upon which was determined the justness and reasonableness of the stock exchange ratio was closed in 1962. Although the record was reopened, and a further hearing held in the spring of 1967, to update it with reference to the estimated savings that might result from the merger of railroad operations, the Committee's timely petition for updating the record with particular regard to the valuations of the natural resources properties of Northern Pacific was denied in the Commission's Second Report on Reconsideration dated April 11, 1968 (331 I.C.C. 869, J. App. 463). This denial, we submit, was both an abuse of administrative discretion and a denial to the Northern Pacific stockholders represented by the Committee of their rights not to be deprived of their property without due process of law. *Atchison, Topeka & Santa Fe Railway Co.* v. *U. S.*, 284 U.S. 248.

The court below in sustaining the Commission's action in denying a further hearing erred as well by failing to observe the requirements of 5 U.S.C. 706(2)(A), (B) and (D) mandating a set-aside of agency action found to be (A) an abuse of discretion, (B) contrary to constitutional right, and (D) without observance of procedure required by law.

This error was crucial in the determination of just stock exchange ratios because a merger—like a mar-

riage—looks solely to the future (Tr. 391). The issue is the future prospects of the contributions being made by the stockholder groups. By a denial of the opportunity to put in the record current facts bearing on future prospects, a grave injustice is being done to Northern Pacific stockholders in this case.

The Court well characterized the requirements for a valid forecast of future prospects in a reorganization case, *Consolidated Rock Products Co., et al.* v. *DuBois,* 312 U.S. 510, where it said at 526:

> "Since its application requires a prediction as to what will occur in the future, an estimate, as distinguished from mathematical certitude, is all that can be made. But that estimate must be based on an informed judgment which embraces all facts relevant to future earning capacity and hence to present worth, including, of course, the nature and condition of the properties, the past earnings record, and all circumstances which indicate whether or not that record is a reliable criterion of future performance."

Law as to Time of Determination of Stock Exchange Ratios

In *Schwabacher* v. *United States, supra,* the Court laid down the test of just and reasonable stock exchange ratios in terms of "*current* worth", "what value he [stockholder] *is contributing*" and "*present* intrinsic or market value" (emphasis supplied). Quite obviously a stockholder of a corporation contributes nothing to the new company in a consolidation until consummation of the merger and until he surrenders his stock and receives in exchange stock in the new company.

This was stated by the Court more explicitly in *S.E.C.* v. *Central-Illinois Corporation,* 338 U.S. 96.

Although dealing with the S.E.C. and a plan for dissolution of a utility company, the Court, citing the *Schwabacher* case with approval as to investment valuation, said at page 139:

> "It was the Commission's duty in passing upon the fairness and equity of the plan to accord each security holder . . . the investment or going-concern value of his security . . . . Valuation on the basis of a going concern necessarily has primary relationship to value *as of the time the shareholders' surrender becomes effective,* not as of some earlier, remote period or one long afterward." (Emphasis supplied)

This result must follow, if injustice is not to occur.

The Committee does not suggest that the Commission must continually keep granting further hearings on every fluctuation of earnings or circumstances. The Committee does insist that when through the lapse of time a basic turnaround in earnings has occurred and when there are radical changes in economic and monetary conditions, denial of a further hearing is an abuse of the Commission's normal discretion because this denial results in stock exchange ratios that are not just and reasonable.

Nature and Extent of Evidence Available on a Further Hearing

A brief indication of some of the substantial changes which have taken place since 1960 shows clearly the substantiality of the error of the Commission's action:

1. The trend of earnings in favor of Northern Pacific.

2. Upward trend of gross revenues and net income from the natural resources properties of Northern Pacific.

3. Turnaround in the market prices of the stocks of the two Northern Lines now favoring Northern Pacific.

4. Increased dividends of Northern Pacific.

5. Increased net assets per share being contributed by Northern Pacific as a result of its continuing lower percentage dividend payout.

6. Accelerated pace of development of Northern Pacific's natural resources properties.

7. Further diversity of operations of Northern Pacific stemming from charter changes and acquisitions.

8. Radically changed national economic and monetary conditions having a direct and favorable effect on the value of Northern Pacific's natural resources properties.

Invalidation of Claimed Bases of Merger Terms by New Evidence

A comparison of the applicants' evidence in the record with the new evidence available shows clearly the injustice of the proposed merger terms to Northern Pacific stockholders.* These new facts, not available

* In considering this comparison it must be kept in mind that under the proposed merger terms both Great Northern and Northern Pacific stockholders would receive common stock of the New Company on a share for share basis but Great Northern stockholders only, in addition, would each receive one-half of a share of the New Company's $10 par value 5½% preferred stock for each share of Great Northern stock. This preferred stock is to be retired over a 25 year period beginning on the fifth anniversary of the consummation of the merger and could be redeemed after that fifth anniversary. Thus, Northern Pacific stockholders will not even be able to achieve *parity* with Great Northern stockholders for 30 years *after consummation*.

to the negotiators, have proved false the assumptions on which they based the proposed merger terms.

1. The applicants' testimony as to relative net incomes was:

> "During the five year period 1955-1959, inclusive, Great Northern's net income after fixed charges and other deductions had averaged $29,016,596 annually, compared to $21,409,251 for Northern Pacific. The year 1959 was the year of the steel strike when Great Northern's iron ore tonnage was the lowest of any year since the depression year of 1939. Even in the depression year of 1960, when income from natural resources cushioned the effect of the depression on Northern Pacific's earnings, Great Northern's net income exceeded Northern Pacific's by $2,176,020.
>
> "There is nothing reasonably foreseeable to indicate that Northern Pacific's future earnings prospects are better than Great Northern's" (Tr. 119-120).

The turnaround in net earnings of the two companies, shown in Appendix IV, on both an absolute and relative basis, shows how dangerous it is to take past earnings as the principal gauge of future prospects. This trend, evident in 1960 and favorable to Northern Pacific stockholders, according to Great Northern's financial consultant was "largely due to the Northern Pacific's increased revenues from its natural resources properties" (Tr. 2552). This continuing trend confirms the Committee's evidence of the favorable prospects to be expected from the development of Northern Pacific's natural resources properties (Tr. 9894-99; 9917-18; 9925-6; Com. Ex. 146, pp. 3-13; Com. Ex. 147; Tr. 10061-71).

2. As to the gross revenues of these natural resources properties, the Northern Pacific chief negotiator as-

sumed in 1960 that oil and gas reserves were being depleted at a faster rate than replacement from new discoveries and "that unless substantial reserves were added and added quickly that the oil income would trail off I would say sharply, but downward rather rapidly" (Tr. 1030).

An examination of the *actual* gross revenues from all natural resources received to date, shown in Appendix V, *infra,* makes clear how wrong the applicants were in this assumption.

3. As to the net income from those natural resources properties, the applicants' direct testimony was:

"On the other hand, the withdrawal of Northern Pacific's oil and gas reserves at a faster rate than they are being replaced by new discoveries points to the conclusion that Northern Pacific's income from natural resources reached a peak in 1959, and that over the foreseeable future a leveling off or possibly a decline of those earnings may be expected" (Tr. 120).

Great Northern's financial consultant's forecast of future prospects was even gloomier and more erroneous (Tr. 2597).

Even though the net income from this source cannot be accurately stated, the estimates of such net income after income taxes, furnished by Northern Pacific management are shown in Appendix V, *infra.* These figures clearly belie the erroneous assumptions of the negotiators.

4. As to the market prices of the stocks of the two companies, the applicants' testimony was:

"For the 17-month period from January 1, 1959, through May 1960, the average monthly mean market

price of Great Northern stock exceeded that of Northern Pacific stock by $4 per share" (Tr. 121).

Yet for the first four months of 1969, the average of the closing daily prices of Northern Pacific stock was $.9676 higher per share than the average of the closing daily prices of Great Northern stock rather than $4 lower (*Wall Street Journal*; Tr. 121). This market turnaround is the more significant in view of the fact that Northern Pacific's dividend rate per share is now only $2.60 as against Great Northern's $3, and the further fact that if the merger is consummated on the proposed stock exchange ratios each Great Northern stockholder will receive one-half of a share of $10 par value 5½% preferred stock which Northern Pacific stockholders will not get. We conclude that the persons *really dealing at arms length* in the market place and under no extreme compulsion to achieve a consolidation of railroad properties are recognizing the intrinsic values inherent in the ownership of natural resources properties in an inflationary period.

5. As to dividends, the applicants' testimony in 1962 was:

"Because of Great Northern's better earnings, it has paid higher dividends per share over the past ten years . . . . Great Northern's dividend rate has been $3 per share since 1956, while Northern Pacific's current dividend rate is $2.20 per share and in years prior to 1959 even lower dividends were paid" (Tr. 121).

With future prospects in mind, the significant facts here are (1) that Northern Pacific's dividend rate has been increasing since oil was discovered in the Williston Basin in 1951 to the point where it has hit the

ceiling ($2.60) imposed by the merger agreement, whereas Great Northern's rate has been static, as contemplated by the negotiators who adopted its 1960 dividend rate of $3 as a ceiling, and (2) that Great Northern during this period has paid out a much higher percentage of its earnings in dividends—as is shown in Appendix VI.

6. As to prices and inflationary conditions, the applicants' testimony was that in the negotiations it was assumed that the integrity of the American dollar was assured, that the prices of oil and timber would remain stable and that there would be no substantial inflation (Tr. 1038-42; 1421-2; 2455-7).

Since 1960 there have been radical changes in the national economic and monetary conditions having a direct and favorable effect on the ownership of land and natural resources properties as a form of capital investment. Inflation is now a reality, not a prospect. The American dollar is under extreme pressure: for example, rising labor and other costs; depreciation of purchasing power of dollar evidenced by rising prices of land and art objects; elimination of gold backing of Federal Reserve Notes; restrictions on sale of U. S. gold at $35 per ounce; increase in official price of silver and elimination of convertibility of silver certificates into silver and removal of all silver from coins, except 50 cent pieces; numerous strenuous efforts of the Federal Reserve Board and the executive and legislative branches of the Federal Government to dampen inflation and strengthen the U. S. dollar in the foreign exchange markets.

Furthermore, new oil discoveries on and near Northern Pacific's lands and changes in its corporate policy

have resulted in an intensification of exploration and development of Northern Pacific natural resources properties. More wildcat wells were drilled by other operators on Northern Pacific's lands in 1968 than in the prior five years combined. Northern Pacific is obtaining larger working interests in oil operations. Accelerated field exploration for other minerals has delineated 240 million tons of subbituminous and lignite coal reserves (Northern Pacific 1968 Annual Report to Stockholders, pages 10-12). Also, Northern Pacific's corporate charter powers were broadened in 1966 to enable subsequent acquisitions of other profitable ventures. All this appears likely to produce even higher income to Northern Pacific in the future.

The gravamen of the Committee's complaint is not staleness of the record per se but that the facts currently existing are decisive in determining the issue in this case.

The proposed merger terms are not unjust because they were agreed upon in 1960 but because the facts upon which the applicants claim to have based their agreement, and have obtained Commission and judicial concurrence, have been invalidated by facts occurring since 1960.

Commission and District Court Error

The basic error of the Commission on this aspect of the case lies in not fulfilling the requirements of 5 U.S.C. 554(c)(1) and 556(d).

5 U.S.C. 554(c)(1) in pertinent part provides:

> "The agency shall give all interested parties opportunity for—(1) the submission and consideration of facts, . . . when time, the nature of the proceeding, and the public interest permit. . . ."

The Commission deemed there was sufficient time to permit the applicants in a further hearing to update the record in 1967 as to the possible savings resulting from a merger of the railroad properties and operations. The nature of the proceeding, i.e. Commission approval of a merger proposal, requires not only a finding that the proposal is consistent with the public interest but also a finding that the terms thereof are just and reasonable, *Schwabacher* v. *U. S., supra.* Yet it here denied the Committee the opportunity to present facts, non-cumulative in character, occurring after the close of hearings showing a radical change in earnings and circumstances having a direct and decisive bearing on the justice and reasonableness of the proposed merger terms.

5 U.S.C. 556(d) in pertinent part provides:

> "* * * A party is entitled to present his case . . . by oral or documentary evidence, to submit rebuttal evidence, and to conduct such cross-examination as may be required for a full and true disclosure of the facts. * * *"

The facts to be determined in this case are those pertinent and existing on a date as near as practically possible for the agency to the date of the consummation of the merger—not as of some earlier, remote period, *S.E.C.* v. *Central-Illinois Corporation, supra.*

The nature, relevancy and cogency of the factual evidence available for, but excluded from, the record make it crystal clear that without such evidence in the record it cannot be found that there has been "a full and true disclosure of the facts" in this case.

This denial to the Committee of the opportunity to complete and update the record on this branch of the

proceeding is not only a denial to it of a fair hearing but a denial to the Northern Pacific stockholders, whom it represents, of a constitutional right, under the Fifth Amendment of the Constitution, not to be deprived of property without due process of law. *Atchison, Topeka & Santa Fe Railway Co.* v. *U. S., supra.* We go further and urge that it was the duty of the Commission on its own initiative to obtain and to have before it a complete and current record before making an independent determination as to whether or not the merger terms should be approved as proposed by the applicants or modified, as expressly provided by Section 5(2) of the Interstate Commerce Act.

The District Court erred in sustaining the Commission's action in denying a further hearing and in failing to observe the requirements of 5 U.S.C. 706 (2)(A), (B) and (D) which provides in pertinent part as follows:

> "... the reviewing court shall ... (2) ... set aside agency action ... found to be—(A) arbitrary, capricious, an abuse of discretion ... (B) contrary to constitutional right ... (D) without observance of procedure required by law ...."

The opinion of the District Court contains only the following comment on the matter of a further hearing:

> "Moreover, we do not agree that the Commission should be required to reopen the record to update it. We think that such fluctuations as the Committee refers to as possibly relevant are, as the Commission now urges, those normal fluctuations which can be expected to occur during the course of any protracted administrative proceeding and which have no effect upon the ultimate fairness of the Commission's finding. The arguments pro and

con reopening cancel out each other sufficiently to leave the discretion exercised by the Commission free of abuse. *United States* v. *Pierce Auto Lines*, 327 U.S. 515, 534-35" (J. App. 45-6).

First, it is inaccurate for the District Court to characterize the turnaround in relative overall net incomes of Great Northern and Northern Pacific as just "those normal fluctuations which can be expected to occur during the course of any protracted administrative proceeding". The figures in Appendix IV show that during the period since the discovery of oil in the Williston Basin the excess of Great Northern's net income over that of Northern Pacific has gone from a plus of $11,883,493 in 1952 to a minus of $3,384,763 in 1968.

The absolute increase in the net income of Northern Pacific in the same period from $15,821,166 to $25,184,816 represents a gradual upward trend due in large part to the increasing net income from its natural resources properties.

The figures in Appendix V as to the gross revenues and estimated net income from these properties also reveal an upward trend—not fluctuations. These results are attributable to the tree farm development program and in part to the intensification and success of oil exploratory efforts. Net income after Federal income taxes from oil and gas was down $514,000 in 1968 "because of development expenditures on a new field and increased costs involving waterflood projects". (App. V, *infra;* Northern Pacific press release, dated April 24, 1968; Northern Pacific 1968 Annual Report to Stockholders, pages 10-11) While these expenditures and efforts held down 1968 earnings, they enhance Northern Pacific's future earnings prospects.

Second, the District Court misstated the Committee's position in saying that it referred to new evidence of net income as "possibly relevant". We have contended, and still do, that past earnings (even for years as recent as 1967 and 1968) do not fully reflect the potential earning power of Northern Pacific's natural resources properties, and that if such earnings are used as a basis of valuation, a higher price-earnings ratio must be applied to them than is applied to earnings from railroad properties. This was the basis of much of the Committee's direct evidence and is the basis of some of its calculations of proper stock exchange ratios shown in Appendices II and VII, *infra.*

Third, the District Court also gravely erred in holding that the new evidence available as to the changes in overall net income has "no effect upon the ultimate fairness of the Commission's finding" (J. App. 46). The Committee has taken this new evidence and recalculated ranges of stock exhange ratios in Schedules 2 and 3 of Appendix VII. This new evidence radically and favorably affects the amount of stock of the New Company which Northern Pacific stockholders should receive. Schedule 3 of Appendix VII, *infra,* based on testimony of *Great Northern's* financial consultant (Tr. 2572, 2575), shows that taking figures for the latest year, 1968, *Northern Pacific stockholders should receive 1.313 shares of stock of the New Company for every 1 share to be received by Great Northern stockholders,* whereas in Schedule 3 of Appendix II, *infra,* without this new evidence, the ratio for the then latest year, 1961, would be only 1.028 to 1.

The effect of this new evidence on the stock exchange ratios developed in Schedule 2 of Appendix VII also results in a higher ratio of 1.910 to 1 in favor of Northern Pacific stockholders for 1968.

Fourth, the only authority cited by the District Court, *United States* v. *Pierce Auto Lines, supra,* is not apt in the decision of this case. There the issue was the correctness of a remand to the Commission ordered by the District Court to determine the fitness of a motor carrier to initiate and maintain a line in view of war conditions. The Court reversed, and at page 535 in its opinion stated: "The Commission was well acquainted with the impact of the war upon facilities for transport and upon the transportation business in general." Here the issue relates to the valuation of non-transportation properties and in part to the effect of general economic and inflationary conditions on the value of such properties—as to which there is no expertise in the Commission either implied in law or demonstrated in fact.

A more helpful authority in the decision of this case is *Atchison, Topeka & Santa Fe Railway Co.* v. *United States, supra.* The issue in both cases is the same: Whether the Commission abused its discretion in not allowing the record to be reopened. There the interval between the closing of the record and the application for reopening was 2 years and 5 months; here it was 5½ years. There the changed conditions were the onset of a depression; here they are the emergence of a dangerous inflationary boom (likewise radically affecting prices), along with the additional element of an established change in earnings, amounting to a trend, directly affecting the required finding of the Commission as to the justice and reasonableness of stock exchange ratios. What the Court said in that case at page 262 seems peculiarly apt to the facts of this case:

> "This is not the usual case of possible fluctuating conditions, but a changed economic level. And the

prospect that a hearing may be long does not justify its denial if it is required by the essential demands of justice . . . . In discharge of its duty a fair hearing is a fundamental requirement."

Here a further hearing to receive asset valuations of the natural resources properties, evidence of changed economic conditions and statistical evidence updating the record as to net earnings and other factors affecting the determination of just and reasonable merger terms need not be of long duration, particularly with the guidance of the Court as to the proper method of valuation to be employed in this novel case.

IV. THE COMMISSION'S FINDING THAT THE COMMITTEE'S PROPOSED CONDITION, INVOLVING THE SEGREGATION AND SALE OF THE NATURAL RESOURCES PROPERTIES PRIOR TO MERGER TO A NEW LAND COMPANY, WAS WITHOUT MERIT AND UNFAIR TO NORTHERN PACIFIC STOCKHOLDERS, WAS ARBITRARY AND NOT SUPPORTED BY SUBSTANTIAL EVIDENCE IN THE RECORD.

The precise terms of the proposed condition are set forth in Appendix III, *infra*. How little serious consideration was given by either the examiner or the Commission to this proposed condition is shown by the fact that it was not until the Second Report on Reconsideration that the Commission finally even stated its terms correctly (J. App. 471). The finding of the Commission that the proposed condition is without merit and is unfair to Northern Pacific stockholders is completely unsupported in the record.

The vice of the proposed merger terms is that they *require all* Northern Pacific stockholders to lose forever more than 50% of their interest in the natural resources properties, with no other option available (Tr. 9904-5; 9926-7; 14355-6).

As Mr. Macfarlane, then head of Northern Pacific, admitted in the hearing, the proposed Committee plan gives *each* Northern Pacific stockholder a *flexible option* to continue his present 100% beneficial interest in such properties, or any lesser percentage, or none, thereof, by selling sufficient of his Northern Pacific stock to subscribe to his proportionate share of the stock of the land company (Tr. 14349-57).

The Commission was in error in implying in its report on reconsideration that some Northern Pacific stockholders would be unable to exercise their subscription rights to stock of the new land company. At all times during the Commission proceeding and since, Northern Pacific stock has sold for more than twice the $20 subscription price, so that Northern Pacific stockholders have been and are still able to sell sufficient of their present holdings in Northern Pacific stock to raise funds to exercise their subscription rights. Thus there is no danger of any of them being "frozen out" against their wills from ownership in the natural resources properties (J. App. 294, 297; Tr. 14352).

Obviously on his present investment a Northern Pacific stockholder cannot continue to own both these properties and the cash proceeds from their sale. The cash will be substituted for the properties in the hands of the new merged railroad company. In reality a Northern Pacific stockholder would not be repurchasing an interest already owned. Under the plan he alone, having in mind his own circumstances and preferences, would determine how much of his present investment in Northern Pacific he would retain in railroad and how much in natural resources properties. Thus, the Commission after having corrected its misstatement has no basis in the record to support its find-

ing that the plan is unfair to Northern Pacific stockholders.

Moreover, Great Northern stockholders would not be hurt by the proposed condition. The new merged company would merely receive cash in lieu of the natural resources properties. This cash would be available for needed capital improvements to achieve the savings expected from a merger of railroad operations (Tr. 138-9) and to facilitate the reduction of debt and fixed charges.

Merit of Proposed Condition

Segregation of the natural resources properties would enable management to concentrate on the management of the railroad (Tr. 14346). Continued ownership of such properties, according to the head of Northern Pacific, is not essential to the operation of Northern Pacific as a railroad, and past extensive sales of land grant lands had not adversely affected its operation as a railroad (Tr. 14345).

Segregation was actively sought in the negotiations leading to the merger proposal and was abandoned only when it was erroneously concluded that the natural resources properties would have to be included in the merger (Tr. 97-8). The negotiators never considered sale of these properties as proposed by the Committee (Tr. 1042; 1045-6; 1165; 14344-5; 1425; 2432; 2435; 2436).

As a matter of policy the Commission directed segregation of oil and gas properties by a motor carrier in *Jordan Bus Co. Purchase,* 58 MCC 296, 300, in these terms:

> "We are of the opinion, however, that motor common carriers of passengers or property should be

> sustained primarily as a result of revenues received directly from their transportation service to the public and activities related thereto. The record is convincing that applicants' services are necessary to the travelling public, and we do not believe they should be disrupted in any way. *However, we are of the opinion that the oil and gas properties should be separated from the transportation business of vendee as soon as practicable.*" (Emphasis supplied)

Thus, from the record segregation of these properties appears to be desirable and possible. For example, segregation of large land interests of Atlantic Coast Line Railroad Company was achieved shortly before its stockholders approved the merger of its railroad properties with those of Seaboard Air Line Railroad Company (1960 Annual Report to Stockholders of Atlantic Coast Line Railroad Company, p. 21).

The proposed plan of segregation is feasible and legal. Mr. Sutton, the only underwriting expert to testify, stated that the proposed purchase price could be raised "without any difficulty" and that there was no question that from an underwriting point of view the proposal was financeable (Tr. 10054).

Applicants' witnesses testified that these properties could be sold (Tr. 1047, 2435) and released from the lien of the Prior Lien Mortgage (Tr. 14363-4; Com. Ex. 32, p. 22) and that in the 66 years since these properties had stood as security under the mortgages no mortgage trustee had ever even thought it necessary to seek court approval, although during this period the land grant acreage had been reduced by sales from 39,473,369 acres (Tr. 14360) to the present 8,314,000 acres (Tr. 14365-6; 14452-3; 14462; 14465).

As to the purchase price Mr. Macfarlane testified for the applicants that the new land company proposed to purchase the natural resource properties at approximately the value thereof fixed in determining the present merger terms, plus an approximate amount of capital gains resulting from such sale (Tr. 14358). Even if on an updating and broadening of the record on the valuation of these properties a higher price were deemed to be fair by the Commission, it could appropriately alter the proposed condition as present values might warrant.

District Court Error

The District Court erred in not reviewing, as required by 5 U.S.C. 706, the part of the record dealing with this proposed condition although cited to it by the Committee in its memorandum and on oral argument.

Although the matter of the stock exchange ratio of the merger terms is discussed in the District Court's opinion (J. App. 42-46), there is no reference to or discussion of this proposed condition, indicating any review thereof. The adoption of this condition would require no change in the proposed stock exchange ratios and thus might facilitate the consummation of a merger of railroad properties.

But if for any reason the Court should not deem this question of segregation crucial, appellants respectfully call the Court's attention to the testimony of the Committee in 1962 that Northern Pacific stockholders should receive vis-a-vis Great Northern stockholders *a minimum* of stock of the New Company in a ratio of 1.5 to 1 without any provision for preferred stock (Tr. 9925). Current facts would warrant a substantially higher ratio.

CONCLUSION

For the foregoing reasons, the judgment of the District Court should be reversed, the prayers of the appellants' complaint should be granted and the matter should be remanded to the Interstate Commerce Commission for further action in accordance with the directions of the Court.

Respectfully submitted,

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